No. 15,645

United States Court of Appeals

For the Ninth Circuit

HAROLD M. KOCH, BESSIE KOCH, WILLIAM L. KOCH, ROSE KOCH, REBECCA KOCH ABEL, MAURICE P. KOCH, and DAISY KOCH,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

On Appeal from the United States District Court for the Northern District of California.

APPELLANTS' REPLY BRIEF.

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ARGUMENT.

I.

THE ERRONEOUS INTERPRETATION OF THE TERM "ENGAGE IN THE BUSINESS OF FINANCING MOTION PICTURE PRODUCTIONS".

The errors during trial, now emphasized by Appellee's Brief, resulted from an erroneous interpretation of the phrase taken from the partnership agreement (Appellants' Brief, Appendix B), i.e., ". . . engage in the business of financing motion picture productions . . ." The term "finance" and the corresponding term "financier" must be defined as the con-

duct of financial affairs and negotiations respecting the same. Definition must include negotiation for participating interests, profits, and other considerations which prompt and promote all business activity.

At the time of trial, as well as in its brief, appellee asserted that engaging in the business of financing motion picture ventures means only the making of loans, and that only consummated loans are relevant for consideration in determining whether or not the loss in question resulted from an isolated transaction, as distinguished from the conduct of business. Unfortunately, appellee was substantially supported in its views by the trial Court.

In every motion picture venture appellants negotiated for substantial participation by way of ownership, and assignments of income and profits. Each transaction contemplated profit and ownership participations, as distinguished from simple interest for the funds advanced. Thus, appellants became the assignee and largest owner of the profits and benefits of the picture "Copacabana" from which the $90,000.00 loss resulted. We do not deem it necessary that the respective transactions receive definite labels or precise legal definitions. See *Nelson v. Abraham,* 29 Cal. 2d 745, 177 P. 2d 931; *Hyman v. Hyman,* 98 C.A. 2d 463, 220 P. 2d 623. It is sufficient to note that in each instance it was contemplated that the partnership would contribute cash, whereas others contributed artistic talents, services, etc.

It is true that in some instances the partners created corporations which the partnership owned, con-

trolled and operated for the purpose of advancing its film activities. All corporate expenses were paid by the partnership, and the partners acted in respect to the corporation only to promote the partnership business.

See *Giblin v. Commissioner* (1955), 227 F. 2d 692 (C.C.A. 5), which held that the taxpayer was entitled to a business bad debt deduction in connection with a loan to a company he had promoted, stating:

> "Petitioner's right to deduct the amount of the cancelled debt depends not upon his showing, as the Tax Court seemed to think, that he was in the business of lending money, but rather that he was regularly engaged in the business of 'dealing in enterprises,' during the course of which he operated either as a proprietor, as a stockholder, as a partner or as a lender or in a combination of these capacities, contributing to each enterprise his own initiative and energy, and such financial backing as it required."

In that case the Court also held as time and effort spent on taxpayer's business, the time he spent on the affairs of the corporation he formed, as this activity was part of his individual business.

Appellee argued to the jury and now in its brief that acts in connection with the corporations formed by the partnership cannot be regarded as activities of the partnership. Although we do not suggest that every act of a corporation thus formed is the act of the partnership, we urge that every act of a partner of H. Koch & Sons in furthering the business of these corporations was a business act of the partnership. The

partnership activated corporations in order to have a vehicle to finance and through which the partnership's funds could be utilized for such financing.

In *Commissioner of Internal Revenue v. Stokes' Estate,* (1953), 200 F. 2d 637 (C.C.A. 3), the Court held that the taxpayer was engaged individually in the business of exploiting patents even though the activities were conducted through corporations activated by him. The Court specifically considered *Dalton v. Bowers* (1932), 287 U.S. 404; *Burnet v. Clark* (1932), 287 U.S. 410; *Higgins v. Commissioner* (1941), 312 U.S. 212, and other cases cited by appellee and distinguished the same. The Court held:

> "That the evidence established that his activities in locating, developing and exploiting patents involved much more than the mere investment of funds in and management of corporations."

Foss v. Commissioner (1935), 75 F. 2d 326 (C.C. A. 1) and *Kales v. Commissioner* (1939), 101 F. 2d 35 (C.C.A. 6), which hold to the same effect, are cited with approval by this Honorable Court in *Maloney v. Spencer* (1949), 172 F. 2d 638 (C.C.A. 9); and this Honorable Court in that case distinguished substantially the authorities cited by appellee and held that the taxpayer was engaged "in the business of acquiring, owning, expanding, equipping and leasing food processing plants".

II.

THE PARTNERSHIP AGREEMENT WAS MISINTERPRETED AND THE ENTIRE PRESENTATION AND CONSIDERATION OF THE CAUSE WAS PREJUDICED THEREBY.

The cause was essentially tried and determined by the trial Court. The trial Court made its findings of fact, and conclusions of law, and granted judgment. The parties could only agree upon one interrogatory to be propounded to the jury and therefore, by stipulation, all other matters were left for determination by the trial Court (R. 293).

The interrogatory was: "During the year 1947, was H. Koch & Sons regularly engaged in the financing of motion picture ventures?" The answer to this interrogatory required (a) proper interpretation of the partnership agreement; and (b) determination as to whether or not the transaction from which the loss resulted was an isolated transaction as distinguished from a course of business. In this latter respect it became essential to consider each and all of the activities of the partnership to establish the time and effort expended and continuity of activity.

(a) The trial Court misinterpreted the partnership agreement (Appellants' Brief, Appendix B, page x) and thereby prevented fair and appropriate consideration of the facts.

The agreement provided:

> ". . . engage in the business of financing motion picture productions . . . if any individual partner or partners desires to advance any sums toward the above mentioned business activity over

> and above the sum advanced by this partnership that the profits realized on such sums advanced by the individual partners or the partnership shall be divided as follows: . . . The profit on such sum or sums advanced by any one or more partners over and above that advanced by the other partner or partners shall belong to the individual partner or partners so advancing any excess; . . . The losses on any sums advanced by individual partners over and above that advanced by the other partner or partners equally shall be borne wholly by said partner or partners so advancing such excess. . . . Maurice P. Koch is hereby appointed General Manager of that portion of the partnership business . . . and any expenses . . . shall be borne by the said partnership . . . as such General Manager the said Maurice P. Koch is hereby authorized to deal in his own name. . . ."

The pleadings admit that the partners advanced a total of $90,000.00 and that complete loss resulted. The entire sum was drawn from partnership funds; however, after the advancements were made, the partnership was short of cash and Maurice P. Koch borrowed and advanced to the partnership $15,000.00 to replace some of the funds advanced (R. 287). Therefore, under the partnership agreement Maurice P. Koch suffered the loss of $15,000.00 more than his co-partners. The trial Court refused to understand that even though additional funds were advanced by one of the partners, such advances were nevertheless partnership activities and are governed by the part-

nership agreement. By reason of this misinterpretation the trial Court ruled that in order to establish the additional $15,000.00 loss, Maurice Koch had to be individually engaged in the business (as distinguished from the partnership). Admittedly all of his acts were on behalf of the partnership and he was not at any time individually engaged in motion picture ventures. Therefore, without hearing argument, and contrary to the admissions of the pleadings, the Court granted dismissal (or directed verdict) against Maurice P. Koch (and his wife) with regard to the added $15,000.00 loss (R. 292) and the Court made its finding (Finding No. 6, R. 8) that only $75,000.00 was lost, in the face of pleadings which admit that $90,000.00 was lost.

(b) Perhaps more devastating was the Court's instruction to the jury to disregard all the activities of Maurice P. Koch in his own behalf. Pursuant to the partnership agreement he managed and conducted all of the partnership affairs in connection with films and all documentation was in his name. Each and all of his activities were for the partnership and only for the partnership (R. 43, 44, 45, 56, 57, 72, 76, 96, 97, 101, 112, 122-125). By ruling that Maurice Koch could not assert the $15,000.00 loss because he was not individually engaged in the business, the trial Court ruled as a matter of law that he had absolutely no activities in motion picture ventures on his own behalf. Nevertheless the Court instructed the jury that it could not consider Maurice Koch's activities on his own behalf in determining whether or not the partner-

ship was engaged in the business (R. 302). Exception was taken (R. 311-312). There is absolutely no theory of fact in the entire case on which such an instruction could have been predicated. The suggestion thus made that he was engaged on his own behalf was prejudicial. By the terms of the formal partnership agreement Maurice Koch was the Manager of the partnership; managed and conducted all of the picture activities; and was authorized to act in his own name. Under the instruction the jury was prone to disregard all documentation bearing his name, and all activities conducted by him, despite the fact that the same were partnership activities and paid for by the partnership in every respect. This prejudicial error was then compounded by the Government argument to the effect that his activities must be disregarded (R. 349, 352-354). Having captured a directed verdict or dismissal on the Court's own motion, the Government then proceeded to advise the jury that Maurice Koch's activities were in his own behalf and not for the partnership and that his activities should not be considered. Since he conducted all of the activities of the partnership, the prejudice is evident.

Regardless of what action the jury may have taken, the Court's findings on the subject are in error. The pleadings admit the loss of $90,000.00, not $75,000.00 as found by the Court (Finding 6; R. 8). The Court failed to make a finding that all of Maurice Koch's activities were on behalf of the partnership, though the Court ruled, as a matter of law, that all of his activities were on behalf of the partnership. On the other

hand, the Court made a finding that Maurice Koch was not individually engaged in the business despite the fact that there was no issue thereon (Finding 10; R. 10). These findings merely emphasize the Court's erroneous interpretation of the partnership contract and the issues in the cause. The entire cause was tried and determined upon these false premises.

III.

CORRECTION OF FACTS.

Space does not permit complete correction of appellee's statements of facts; however, we note particularly the following:

(1) Appellee's statement regarding the $15,000.00 advanced to David Sebastian is incorrect. This sum was advanced to organize and activate Beacon Pictures Corporation for the production of the picture "Copacabana". The check for this amount was received in evidence as Exhibit 6 (R. 47). The check was drawn by the partnership on partnership funds and had no particular connection whatsoever with the $15,000.00 additional loss suffered by Maurice Koch by reason of an equal sum contributed by him to the partnership some seven months later. The stock of the corporation had to be held (pursuant to Exhibit 5 for identification) (Appellants' Brief, Appendix D, page xvi) in the name of Koslow, although by said agreement, which the Court erroneously rejected, the corporation could then assign proceeds and profits received from the picture to others. The pleadings

admitted the loss of all funds alleged to have been lost and there is no issue regarding same. In any event, it was clear that these funds would only be repaid in the event the picture was successful and proceeds were received (R. 250-252). Admittedly the sums were lost; there is no issue thereon; and the argument has no bearing on this case.

(2) Ambassador Productions, Inc. was also formed in order to "package a deal" to finance. The shares were issued in the name of Maurice P. Koch pursuant to the partnership agreement which authorized all transactions to be conducted in his name. The mere existence of the corporation does not negative the partnership activities in regard to the corporation as well as by means of the corporation.

(3) Producers Finance Corporation was also formed and conducted by the partnership, at partnership expense. The purpose was likewise to create a situation which required financing and to also provide a means for raising funds from others.

(4) Admittedly Maurice P. Koch and the various attorneys for the partnership were officers and directors of the various corporations which were formed and activated; however, this was done to promote partnership purposes. The argument by appellee to the jury and in its brief that when Mr. Koch or the attorneys become directors or officers of the corporation, their acts are no longer acts of the partnership is untenable.

(5) Appellee's Statement of The Case lists only a few activities and omits the fact that during the exact

time in question appellants conducted many other film financing matters as disclosed by the record (R. 62, 63, 67, 68, 75, 76, 77, 78, 80, 81, 82, 83, 84, 85, 86, 87, 89, 90, 91, 92, 93, 94, 95, 97, 98, 99, 100, 104, 106, 107, 108, 110, 111, 112, 113, 114, 122, 123, 124, 125, 126, 127, 128, 129, 130, 132, 134, 159, 161, 165, 166, 173, 174, 176, 183, 184, 191, 192, 193, 194, 198, 199, 201, 202, 208, 209, 210, 213, 214, 215, 216, 218, 220, 221, 231, 234, 235, 236, 237, 238, 239, 240, 241, 242, 243, 244, 247).

IV.

RE THE PRESUMPTION OF CORRECTNESS OF DETERMINATIONS BY THE COMMISSIONER OF INTERNAL REVENUE.

(a) The Government had no witnesses and, in fact, offered no testimony which could in any manner affect the determination of the cause. The Government's defense was based entirely upon the alleged presumption of correctness of the determination by the Commissioner of Internal Revenue. Meticulous examination of the record reveals absolutely no materials, testimony or evidence upon which a defense could be predicated in the absence of such alleged presumption.

(b) The effect of the presumption was discussed with the trial Court and the Court made its position quite clear upon the subject during the trial and before arguments and instructions.

(c) This was, in fact, a trial by the Court and not by the jury whose function was limited to a single interrogatory. The erroneous ruling with regard to

this presumption of correctness of the Commissioner's determination was the basis for the trial Court's findings of fact, as well as conclusions of law.

(d) The Court ruled clearly during the trial, during argument, during instructions, in its findings of fact, in its conclusions of law, and in its judgment that there was a presumption that the determination by the Commissioner of Internal Revenue that the plaintiffs were not engaged in the trade or business of financing motion pictures was correct; and that the burden was upon plaintiff to overcome the presumption of the correctness of the Commissioner's determination by *a preponderance of the evidence* (R. 9, 301, 344). Unfortunately, considerations of the subject off the record do not appear.

(e) For the reason that it constituted the only defense of the Government, the matter of the presumption and overcoming the same became the *central issue in the case.*

(f) Contrary to the rule repeatedly announced by this Honorable Court holding that after evidence is introduced "the Commissioner's determination is no longer existent" . . . "The issue depended wholly upon the evidence" . . . "Find from the evidence and from it alone" . . .[1], the trial Court consistently enforced its

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[1]The words are excerpts from the Ninth Circuit cases as follows:

San Joaquin Brick Co. v. Commissioner of Internal Revenue (1942), 130 F. 2d 220, 225;

Hemphill Schools v. Commissioner of Internal Revenue (1943), 137 F. 2d 961, 964;

Lawrence v. Commissioner of Internal Revenue (1944), 143 F. 2d 456.

erroneous rule that the presumption survived all evidence in the case. Thus the presentation of the cause was necessarily required to conform to the law of the case as determined by the trial Court and as counsel knew the Court would instruct the jury, and upon which the parties knew the Court would premise its findings and conclusions. Under this erroneous concept, a prima facie case could not survive because it was here necessary to overcome the presumption by a preponderance of evidence.

(g) As stated in *Harlem Taxicab Association v. Nemesh* (1951), 191 F. 2d 459, 461, where the Court considered erroneous instructions regarding the effect of a presumption and to which no exception had been taken:

> "But the court had repeatedly stated its view of the law in the course of the trial and had repeatedly prevented appellant's counsel from proceeding on the opposite view. 'The purpose of exceptions is to inform the trial judge of possible errors so that he may have an opportunity to reconsider his rulings and if necessary correct them.' It would have been only a formality to ask the court at the end of the trial to reverse itself. An error in instructing a jury may be raised by an appellate court, when justice seems to require, even though it cannot be raised by the appellant."

After the cause had been tried on the erroneous theory of law, and after the trial Court had specifically considered the proposition of law, and after argument by counsel framed in accordance with the trial Court's

view of the law, and after the erroneous instructions by the Court in accordance with the erroneous rulings, —the formality of requesting the Court to make corrections in its instructions to the jury would have been nugatory and a sham. Only a new and different trial could obviate the error.

(h) In *Hormel v. Helvering* (1941), 312 U.S. 552, 557, 61 S.Ct. 719, 85 L.Ed. 1037, the Supreme Court stated:

> "Rules of practice and procedure are devised to promote the ends of justice, not to defeat them. A rigid and undeviating judicially declared practice under which courts of review would invariably and under all circumstances decline to consider all questions which had not previously been specifically urged would be out of harmony with this policy. Orderly rules of procedure do not require sacrifice of the rules of fundamental justice."

(i) See appellee's argument to the jury re "plaintiffs already had one crack at this case" (R. 344 and the Government's final emotional appeal to the jury: "we submit to you, ladies and gentlemen, the finding of the Commissioner of Internal Revenue, who was duly and legally appointed executive officer of the Government, sworn to administer internal revenue laws, . . ." (R. 370-371).

We submit, without painstaking or apology, that the Government's entire argument to the jury was shocking in the extreme. The same did not adhere to the known law of the case; was based upon misstatement

of law and fact, and the officer of the people and whom the jury therefore received as their own adviser, effectively and passionately injected mistrust, contrivance, unwarranted personal attacks, and in finality rested upon the "duly and legally appointed and executive officer of the Government sworn to administer revenue laws . . .", to wit: the determination of the Commissioner of Internal Revenue, as the basis for the jury's finding.

(j) Even though Fed. R. Civ. P. 51 may apply to the special type of trial had in this cause, this Honorable Court nevertheless has the inherent power to note "plain error" related to the central issue in the cause in order to prevent manifest injustice.

We note that all of the Circuits (with the possible exception of the Ninth Circuit), to the extent that the question has arisen, have held that Appellate Courts may apply the doctrine of "plain error". See *Giacalone v. Raytheon Manufacturing Co.* (1955), 222 F. 2d 249 (C.C.A. 1), where the Court stated:

> "It does not follow from this, however, that under no circumstances can we consider the error on our own volition."

The Second Circuit recognizes the rule in the following cases:

Moore v. Waring (1952), 200 F. 2d 491;
Finn v. Wood (1950), 178 F. 2d 583.

The Fourth Circuit considers the matter in *Hite v. Western Maryland Railway* (1954), 217 F. 2d 781, 782:

> "If there had been error in the instruction to the jury which in our opinion had led to a miscarriage of justice, we might notice it under our power to notice plain error not assigned to prevent injustice, but there was no such error."

The Fifth Circuit stated in *Louisiana & Arkansas Railway Company v. Moore* (1956), 229 F. 2d 1:

> "However, since it goes to the central issue in the case . . . we may consider it under the general rule which allows an appellate court to notice plain errors, although they were not properly excepted to below."

To the same effect, see *United States v. Chemell* (1957), 243 F. 2d 944 (C.C.A. 5).

The Eighth Circuit recognizes the rule in *O'Malley v. Cover* (1955), 221 F. 2d 156.

The Tenth Circuit also recognizes the rule in *Allen v. Nelson Dodd Produce Co.* (1953), 207 F. 2d 296, 297.

The Court of Appeals for the District of Columbia enunciated the rule in *Harlem Taxicab Association v. Nemesh, supra.* This Court has enacted its own rule for that District, enunciating that that Court will notice and pass upon "plain error", and has exercised this power in situations where there is failure to comply with said Rule 51. By adopting its own rule relating to "plain error", that Court has held that Rule 51 does not eliminate the inherent power of the Court to pass upon matters of "plain error" to prevent injustice. See also *Montgomery v. Virginia Stage Lines* (1951), 191 F. 2d 770 (C.C.A.D.C.).

For comparison, see also *Hormel v. Helvering, supra.*

This Honorable Court gave consideration to the matter of "plain error" in *Walker v. West Coast Fast Freight, Inc.* (1956), 233 F. 2d 939 (C.C.A. 9), and in *Flintkote Company v. Lysfjord* (1957), 246 F. 2d 368 (C.C.A. 9).

Since rules of procedure should not require sacrifice of the rules of fundamental justice, we fervently trust that this Honorable Court will announce the rule of "plain error" in accordance with the holding of all other Courts which have passed upon the matter. However, in this cause the trial Court made its own findings and conclusions based upon the view that the presumption persisted and had more probative value than the evidence offered, and the trial Court granted the judgment. The trial Court likewise permitted argument to the jury, over appellants' objection, upon this same erroneous theory. It is, therefore, not necessary to invoke the doctrine of "plain error" in order to reverse the trial Court.

V.

APPELLANTS WERE ENGAGED IN A TRADE OR BUSINESS WITHIN THE MEANING OF THE INTERNAL REVENUE LAW.

Four persons *agreed by formal agreement,* executed some years prior to the loss in question to enter into a business and did, in fact, enter into the business and pursue the same over a course of years. All of the cases on the subject which have gone into the details

of activities are, in fact, merely probing the intention of an individual who may or may not have formed the intent to conduct particular operations as a business. Never before has the question been raised in a situation where two or more persons have agreed to enter into a particular business and have actually pursued the same. The final issue is a matter of intent, e.g., a builder may be in the building business although he never completes his first structure; a lawyer is in such business even though he never gets a case. The only reason why the Courts permit the probing of activities is to establish the intent by the overt acts. In the present cause, the intent of the four partners was established by their written contract and acts thereunder years prior to the time in question. We submit that there is no case in which two or more people have agreed by written agreement to engage in a certain business which has previously been challenged by the Government. We submit that there is no basis for such challenge and the parties to the agreement are entitled to recognition of the terms thereof. The Government cannot tell taxpayers that they may not engage in a particular business in accordance with their formal agreement.

If a profit had resulted from the sale of an interest acquired, the Government would not permit capital gain treatment. The Commissioner would take the obvious position that by their own agreements appellants were "in the business" of financing picture ventures and as such are not entitled to capital gain treatment. On the other hand, the Government now argues that the loss is a capital loss despite the fact

that by their solemn agreement and conduct appellants engaged in the business and could not realize a capital gain.

Appellee admits that one may be in the business of making loans and that one who merely made a number of loans to film companies would be in a business recognized for tax purposes. On the other hand, appellee argues that one who expends money, time and effort to locate artistic elements, and to set up production vehicles, and who raises funds and utilizes the same in the preproduction costs in connection with films, is not engaged in a business recognized for tax purposes, no matter how much money, time and effort is expended in this activity. The argument is untenable.

VI.

CONCLUSION.

We respectfully submit that the cause should be remanded to the trial Court for the computation of the amounts due appellants. In the alternative, we submit that the judgment should be reversed and the cause remanded for trial.

Dated, San Francisco, California,
June 2, 1958.

Respectfully submitted,
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